IN THE

Supreme Court of the United States

October Term, A. D. 1940.

No. ....

ANNA L. RAYMOND,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

OPINIONS BELOW.

References to the opinions below are supplied in the Petition (page 2).

STATEMENT OF THE CASE.

A statement of the case has been given in the Petition (pages 4-9), and to avoid duplication is not repeated.

SPECIFICATION OF ERRORS.

The errors intended to be urged are those specified in the Petition (pages 10-11).

SUMMARY OF ARGUMENT.

1. The consideration paid for petitioner's annuities, within the meaning of Section 22(b)(2) of the Revenue Act of 1934, or for the purpose of determining gain under Section 22(a), was the entire amount transferred by petitioner under the agreements.

(a) The entire amount transferred by petitioner was the exchange or price required and received by the institutions for the annuities.

(b) The language of the statute (the "consideration paid") should be read in its natural and ordinary sense. The total amount transferred is universally called the consideration for such annuities by the parties.

(c) The Treasury Regulations, impliedly approved by Congress, indicate that the usual amount required by charitable corporations for annuities is the consideration paid for them within the meaning of the Revenue Acts.

(d) The conclusion of the Circuit Court of Appeals that the consideration did not exceed the prices charged by insurance companies for similar annui-

ties is irreconcilable with the admitted facts that the institutions were unwilling and could not afford to agree to pay the annuities for such consideration.

2. Section 22(b)(2) of the Revenue Act of 1934 should be construed not to apply to petitioner's annuities.

(a) Congress did not intend that Section 22(b)(2) should apply to annuities paid by charitable corporations.

(b) Section 22(b)(2) should be construed not to apply to annuities purchased before its passage.

3. Section 22(b)(2) of the Revenue Act of 1934, if and in so far as it includes in petitioner's gross income for 1934, three per cent of the consideration paid for her annuities, before the entire consideration has been recovered, is unconstitutional and void.

(a) The statute imposes a direct tax on capital without apportionment among the states according to population, and contravenes the provisions of Article I, Section 2, Clause 3, and of Article I, Section 9, Clause 4, of the Constitution of the United States. Until the consideration paid for an annuity has been recovered, the annuity payments are wholly a return of capital and no part of them can constitute income.

(b) The statute imposes a tax on estimated average income without regard to actualities, is arbitrary and capricious, and contravenes the due process clause of the Fifth Amendment to the Constitution.

ARGUMENT.

I.

The consideration paid for petitioner's annuities, within the meaning of Section 22(b) (2) of the Revenue Act of 1934, or for the purpose of determining gain under Section 22(a), was the entire amount transferred by petitioner under the agreements.

A. The Ordinary Meaning of Consideration.

Williston on Contracts (Rev. Ed. 1936), Volume 1, page 319, after giving as a definition of consideration, "the exchange or price requested and received by the promisor for the promise", continues:

> "This idea is undoubtedly the fundamental and as to most cases the generally accepted idea of consideration at the present time. It is in this sense that the word is used in this treatise and in the Restatement of Contracts."

Similar definitions are given in the American Law Institute's Restatement of the Law of Contracts (1932) Volume 1, pages 80-81; and in *Phoenix Life Insurance Company* v. *Raddin,* 120 U. S. 183, 197.

In the instant case, the annuity agreements could not have stated more clearly that the entire amount transferred by petitioner was the consideration paid for the annuities (R. 35-48). This is confirmed by the Board's

Additional Findings of Fact (R. 124-127). Petitioner asked for and received the largest annuities which the institutions were willing to pay for the amount transferred. The rate of the annuities was substantially the same as under all other annuity agreements made by the institutions. The entire amount transferred by petitioner was the exchange or price requested and received by the institutions for their promises.

The decision of the Circuit Court of Appeals is contrary to *Continental Illinois Bank and Trust Co.* v. *Blair*, 45 F. (2d) 345, 347 (C. C. A. 7th, 1930), and *F. A. Gillespie* v. *Commissioner*, 38 B. T. A. 673, 676 (1938). Neither of these cases was mentioned by the Circuit Court of Appeals.

B. The Language of Tax Statues Should Be Read in its Ordinary and Natural Sense.

The popular or received import of words furnishes the general rule for the interpretation of public laws. *Old Colony Railroad Co.* v. *Commissioner*, 284 U. S. 552, 560; *Woolford Realty Co.* v. *Rose*, 286 U. S. 319, 327; *Helvering* v. *San Joaquin Co.*, 297 U. S. 496, 499; *Deputy* v. *du Pont*, 308 U. S. 488, 493.

In *Old Colony Railroad Co.* v. *Commissioner*, 284 U. S. 552, this Court said, at page 561:

> "In short, we think that in the common understanding 'interest' means what is usually called interest by those who pay and those who receive the amount so denominated in bond and coupon, and that the words

of the statute permit the deduction of that sum, and do not refer to some esoteric concept derived from subtle and theoretic analysis."

So in the present case "consideration" means what is usually called consideration by those who pay and those who receive the amount so designated in these annuity agreements, and that amount is the total amount transferred under the agreement. A division of the amount transferred into "consideration" and "gift" obviously requires subtle and theoretic analysis—it is unreal.

The language throughout the opinion of the Circuit Court of Appeals suggests that the Court assumed that the measure of taxability of the annuities was the "cost" or the "fair cost" of the annuities, and that this "cost" was a theoretical concept different from the consideration paid for the annuities. For example, the Court stated as one of petitioner's arguments (R. 152):

"(2) The regulations in effect for several years (1918-32) (presumably approved by Congress) upheld as the 'cost' of charitable annuities, the entire consideration paid therefor."

However, there is no basis for such an assumption. Under Section 22(b)(2), which the Court held valid and applicable, the measure of taxability was not the "fair cost" of the annuities, but the consideration paid for them. (Appendix A, p. 39.) (See petition for rehearing, R. 158-159.)

It was stipulated that in entering into the annuity agreements, petitioner intended to benefit the institutions (R.

31). Such a motive is often an influence in the selection of the party with whom one will deal in any business transaction. This intention can not convert into a gift some indeterminable part of the consideration which was required and demanded by the institutions. Petitioner transferred to the institutions nothing in excess of their requirements.

Some persons may reasonably have a better opinion of the integrity and financial responsibility of a substantially endowed charitable institution than of life insurance companies. If such persons prefer to buy annuities from charitable institutions and to pay the higher prices which such institutions necessarily require, are they to be penalized? Nowhere in the revenue acts can be found any authority to the Commissioner to limit the measure of exemption of such annuities to something less than the consideration actually charged and paid.

The theory approved by the Circuit Court of Appeals results in the anomalous realization of both deductions and gains from what is obviously one transaction (R. 16-17). The theoretical "gain" is, in fact, only a return of the previous theoretical "gift". Both the "gift" and the "gain" rest entirely on speculation and conjecture. The determination of income taxes on such a basis has been condemned by this Court in *Burnet* v. *Logan,* 283 U. S. 404, 412-413.

C. The Treasury Regulations.

The provisions of the Revenue Acts and Treasury Regulations hereinafter referred to are set forth in Appendix B, pages 42-49.

The Revenue Acts of 1926, 1928 and 1932, contained identically the same provision, expressly excluding annuity payments from gross income until the total amount received exceeded the "consideration paid." The Revenue Acts of 1918, 1921 and 1924 contained a provision in different language but having the same effect. Thus substantially the same provision regarding annuity payments has been re-enacted in every Revenue Act from 1918 to and including 1932.

While in the 1934 Act the provision was changed to include a part of annuity payments in gross income, the "consideration paid" was continued as the basis of their measure of taxability.

Article 62 of Regulations 77 (1932) contained the following provision (Appendix B, page 48):

> "Art. 62. **Annuities and insurance policies.**—Annuities paid by religious, charitable, and educational corporations under an annuity contract are, in general, subject to tax to the extent that the aggregate amount of the payments to the annuitant exceeds the amounts paid as consideration for the contract. . . ."

Substantially the same provision was contained in all income tax regulations from 1918 to 1932, inclusive (see Appendix B, pages 45-48).

Article 22(a)-12 of Regulations 86, relating to the 1934 Act, provides:

> "Annuities paid by religious, charitable, and educational corporations under an annuity contract are, in general, subject to tax to the same extent as annuities from other sources paid under similar contracts. . . ." (See Appendix A, page 40.)

Thus all the income tax regulations from 1918 to 1934 inclusive contained an article dealing specifically with annuities paid by charitable corporations. Yet none of the regulations have ever suggested any division of the amount transferred for the annuities into consideration and gift, or any determination of the consideration paid by reference to mortality tables or insurance company prices. This silence of the regulations is a convincing indication that no such theoretical determination of the consideration was intended.

This Court has often declared that Treasury Regulations, long continued without substantial change, applying to substantially re-enacted provisions of the Revenue Acts, are deemed to have received Congressional approval. *Brewster* v. *Gage*, 280 U. S. 327, 337; *Hassett* v. *Welch*, 303 U. S. 303, 312; *Helvering* v. *Winmill*, 305 U. S. 79, 83; *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U. S. 110, 115.

By re-enacting the statutory provision regarding annuities while the provision of the regulations regarding charitable annuities was continued from 1918 without substantial change, Congress has evidenced its intention that

at least the usual amount required by charitable institutions for annuities is the consideration paid for such annuities, within the meaning of the Revenue Acts.

D. The Court's Conclusion Is Irreconcilable with the Facts.

It is undisputed that the charities were not willing and could not afford to agree to pay the annuities for only the prices charged by insurance companies, for the reason that they made only a few annuity agreements and could not rely on average life expectancies or mortality tables. This appears from the Board's Additional Findings of Fact (R. 125-127, Pars. 6, 8, 11).

In its opinion the Board said (R. 109):

> "The testimony of persons speaking for the several charitable organizations all shows that the institutions were not making a business of selling annuities, that such contracts as these were few and that they could not afford to and would not make an annuity contract with petitioner upon terms as favorable to her as she could get from an insurance company, the point being that the amount received was regarded by them as the consideration for the annuities."

During the years when petitioner's annuity agreements were made, the premium rates of American insurance companies for annuities were based on the American Annuitants' Mortality Table (R. 79). That table indicates a life expectancy for females at age 72 of 11.34 years (R. 81, 102). The petitioner passed her eighty-sixth birthday on January 21, 1940. Therefore if the consideration

for the annuities had been only what the Circuit Court of Appeals has held it to be, the institutions in all probability would already have suffered net losses.

The admitted facts are simply irreconcilable with the conclusion of the majority of the Board and the Circuit Court of Appeals that the charities made these agreements in consideration only for amounts charged by insurance companies or less. The facts compel the conclusion that the consideration paid was substantially greater than insurance company prices.

II.

Section 22(b) (2) of the Revenue Act of 1934 should be construed not to apply to petitioner's annuities.

A. Congress Did Not Intend That Section 22(b) (2) Should Apply to Annuities Paid by Charitable Corporations.

In the debate in the Senate on the new provision, the following discussion occurred between Senator Austin and Senator Harrison, the chairman of the Senate Finance Committee, having charge of the 1934 Act (Cong. Rec., Vol. 78, Part 6, page 5916):

> "Mr. Austin: . . . At this point may I inquire of the chairman of the committee whether it is his understanding that this measure would apply to hospitals and universities, which obtain a large amount of their endowments by selling annuity contracts? Is that the interpretation which would be placed upon the measure?
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> "Mr. Harrison: Mr. President, it does not apply

to them at all. It applies only to persons receiving income. It does not apply to them.

. . . .

"Mr. Austin: . . . Assume that a hospital has received from a philanthropist $100,000 for immediate use by the hospital in erecting buildings, in consideration of which the hospital promises to pay to the donor as an annuity a sum corresponding to 5 per cent annually of the amount of the gift. Would the receiver of that income be a taxpayer, under this provision of the measure?

"Mr. Harrison: It does not apply to him."*

In several cases this Court has given consideration to Congressional debates, and particularly to statements of the chairman of a committee, having charge of a pending bill, as disclosing the intention and understanding of Congress with respect to the scope of the Act. *Hassett* v. *Welch,* 303 U. S. 303, 310; *United States* v. *St. Paul, Minneapolis & Manitoba Railway Co.,* 247 U. S. 310, 316-318; *United States* v. *San Francisco,* 310 U. S. 16, 21-25, 60 Sup. Ct. 749, 752-755.

The report of the Ways and Means Committee of the House on the 1934 Act (Appendix D, page 51) supports the new provision of Section 22(b)(2) by the following statements:

". . . Payments to annuitants are, in fact, based upon mortality tables which purport to reflect a rate

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* This answer of Senator Harrison was omitted from the excerpts from the Senate debate set forth in the footnote in the opinion of the Circuit Court of Appeals (R. 151).

of return sufficient to enable the annuitant to recover his cost and in addition thereto a low rate of return on his investment. The change continues the policy of permitting the annuitant to recoup his original cost tax-free. . . ."

Those statements are not true with respect to annuities paid by charities. Such annuities are not and necessarily cannot be based upon mortality tables, and the change in the law does not permit such an annuitant to recoup his original cost tax-free. If this new provision had been applicable to these annuities in 1925, petitioner could not have recovered her cost tax-free unless she had lived for fifty years after the date of the agreements, or past the age of 121 years.*

B. Section 22(b)(2) of the 1934 Act Should Be Construed Not to Apply to Annuities Purchased Before Its Passage.

Before the passage of the 1934 Act, no part of annuity payments had been regarded as income until the entire consideration for the annuity had been recovered. Petitioner transferred her capital, irrevocably and beyond recall, years before the passage of the 1934 Act, at a time

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* The Circuit Court of Appeals concluded that annuities are not exempt from taxation because paid by a charitable corporation (R. 152). Such annuities will not be exempt even if they are not subject to Section 22(b)(2). After the consideration paid for such annuities has been wholly recovered, the entire amount of annuity payments thereafter received will be subject to tax as gain under Section 22(a) of the Revenue Act (Appendix A, page 39). Such annuities will continue to be taxed in the same manner as under all prior Revenue Acts.

when the imposition of a tax on the annuity payments could not have been foreseen. She cannot now rescind or revoke the agreements nor recover her capital except through the annuity payments. The law thus taxes the return of petitioner's capital pursuant to contracts previously made, and in effect taxes transactions consummated nine years before.

This Court has repeatedly held that a new provision of the estate tax law should not be applied to transfers made before its passage. (*Shwab* v. *Doyle*, 258 U. S. 529, 534-537; *Lewellyn* v. *Frick*, 268 U. S. 238, 251-252; *Blodgett* v. *Holden*, 275 U. S. 142, 148-149; *Helvering* v. *Helmholz*, 296 U. S. 93, 98; *Hassett* v. *Welch*, 303 U. S. 303, 307, 314.) Petitioner contends that the principle of those decisions is applicable here.

III.

Section 22(b) (2) of the Revenue Act of 1934, if and in so far as it includes in petitioner's gross income for 1934, three per cent of the consideration paid for her annuities, before the entire consideration has been recovered, is unconstitutional and void.

A. Section 22(b) (2) Imposes a Direct Tax on Capital Without Apportionment Among the States According to Population, and Contravenes the Provisions of Article I, Section 2, Clause 3, and of Article I, Section 9, Clause 4, of the Constitution of the United States.

Income has been defined as the gain derived from capital, from labor, or from both combined, including profit gained through a sale or conversion of capital assets. *Eisner* v. *Macomber,* 252 U. S. 189, 207; *Goodrich* v. *Edwards,* 255 U. S. 527, 535; *Bowers* v. *Kerbaugh-Empire Co.,* 271 U. S. 170, 174; *Taft* v. *Bowers,* 278 U. S. 470, 481.

In *Bowers* v. *Kerbaugh-Empire Co.,* 271 U. S. 170, 175, it was held that there could not be taxable income or a gain when the result of the whole transaction was a loss.

In *Doyle* v. *Mitchell Brothers Co.,* 247 U. S. 179, this Court said, at page 185:

> "In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

Where the receipt of future payments is contingent upon unpredictable events, no income is received until the capital has been wholly recovered. This rule has been applied to various states of fact. Some of the cases are as follows:

(a) Partial payments received under awards by the Mixed Claims Commission, for property taken by the German Government during the World War: *Commissioner* v. *Speyer,* 77 F. (2d) 824, (C. C. A. 2nd, 1935); *Helvering* v. *Drier,* 79 F. (2d) 501, 503, (C. C. A. 4th, 1935).

(b) Liquidating dividends received from a corporation: *Letts* v. *Commissioner,* 84 F. (2d) 760, (C. C. A. 9th, 1936); *Florence M. Quinn* v. *Commissioner,* 35 B. T. A. 412 (1937); *Alvina Ludorff et al., Executors* v. *Commissioner,* 40 B. T. A. 32 (1939).

(c) Amounts received by partners from the liquidation of a partnership: *Heiner* v. *Mellon,* 89 F. (2d) 141, 143, (C. C. A. 3rd, 1937).

(d) Payments to be received from oil produced from certain property: *Thomas A. O'Donnell* v. *Commissioner,* 25 B. T. A. 956, 961 (1932), affirmed 64 F. (2d) 634, (C. C. A. 9th, 1933); *Rocky Mountain Development Co.* v. *Commissioner,* 38 B. T. A. 1303 (1938). Cf. *Commissioner* v. *Edwards Drilling Co.,* 95 F. (2d) 719 (C. C. A. 5th, 1938).

This Court approved the above rule in *Burnet* v. *Logan,* 283 U. S. 404. There the taxpayer had sold certain cor-

porate stock for cash and a promise by the purchaser to pay in the future sixty cents for each ton of ore taken from a certain mine. This Court held that until the total amount received by the taxpayer should equal her capital, no part of the payments was taxable income. The Court said, on page 412:

> "As annual payments on account of extracted ore come in they can be readily apportioned first as return of capital and later as profit. The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions and speculation. When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was $2,200,000.00 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. Prior to 1921 all receipts from the sale of her shares amounted to less than their value on March 1, 1913. She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture."

The same reasoning is equally applicable to annuities, since an annuity agreement is equally "the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty". It is equally true that an annuitant may "never recoup her capital investment from payments

only conditionally promised''; and that an annuitant may properly demand ''the return of her capital investment before assessment of any taxable profit based on conjecture.''

In the *Burnet* case, this Court further said, on page 414:

> ''If a sum equal to the value thus ascertained had been invested in an annuity contract, payments thereunder would have been free from income tax until the owner had recouped his capital investment. We think a like rule should be applied here.''

One who purchases an annuity for $100,000.00 and dies after receiving but $10,000.00 in payments, has not realized any gain. There can be no gain from an annuity until its cost has been recovered.

Congress cannot transform capital into income by statute, nor impose a direct tax on capital without apportionment by calling capital ''income'', even under the Sixteenth Amendment. *Eisner* v. *Macomber,* 252 U. S. 189, 206; *Burk-Waggoner Oil Association* v. *Hopkins,* 269 U. S. 110, 114.

In *Taft* v. *Bowers,* 278 U. S. 470, this Court said, on page 481:

> ''Under former decisions here the settled doctrine is that the Sixteenth Amendment confers no power upon Congress to define and tax as income without apportionment something which theretofore could not have been properly regarded as income.''

Section 22(b)(2), if applicable, will surely tax capital of this petitioner. She was 71½ years old at the date of the first annuity agreement (R. 29). Under the statute, three per cent of the consideration, or three-fifths (3/5) of her five per cent annuity payments, is considered income, leaving only two per cent of the consideration as a return of capital in each year. If this provision had been applicable to petitioner's annuities in 1925, petitioner would not have recovered her entire capital tax-free unless she had lived for fifty years after the date of the agreements, or past the age of 121 years.

Considering only the actual effect of the new provision in 1934, by the end of 1933 petitioner had recovered $40,000.00 under the first agreement, or approximately forty per cent of the consideration paid (R. 106). If she should recover only two per cent of the consideration tax-free in each year thereafter, she could not recoup her entire capital unless she should live thirty years more, or past the age of 109 years.

Even if the extraordinary view of the Board as to the consideration paid for petitioner's annuities should be approved, the statute would still tax petitioner's capital. The consideration for the last two annuities, as determined by the Board, had not been recovered by the end of 1934 (R. 106, 111). The payments of those two annuities in 1934 were therefore wholly a return of capital; yet a portion of them was included in gross income under the statute (R. 111, 119).

Since the statute taxes a part of each annuity payment before the capital has been recovered, it imposes a direct tax on capital, which is not apportioned among the states, and it therefore violates Article I, Section 2, Clause 3, and Article I, Section 9, Clause 4 of the Constitution (Appendix C, page 50). *Eisner* v. *Macomber*, 252 U. S. 189, 205-206, 219.

B. Section 22(b)(2) Imposes a Tax on Estimated Average Income without Regard to Actualities, Is Arbitrary and Capricious, and Contravenes the Due Process Clause of the Fifth Amendment to the Constitution.

This contention of petitioner was not mentioned by the Circuit Court of Appeals, although urged by petitioner in her brief and in the oral argument.

The House Committee report said, of the new three per cent provision (Appendix D, page 51):

> "While the per cent used is arbitrary, it approximates the rate of return in the average annuity."

Not only the per cent used, but the entire plan of taxing part of each annuity payment as income, is arbitrary and capricious. The statute imposes a tax on each annuitant on the basis, not of his actual income, but of the estimated average income of all annuitants who purchase annuities at insurance company prices. The tax is based on a conclusive assumption of fact without regard to actualities.

An attempt to measure the tax on one person's income by reference to the income of others was condemned by this

Court in *Hoeper* v. *Tax Commission,* 284 U. S. 206, where it was said, on page 215:

> "We have no doubt that, because of the fundamental conceptions which underlie our system, any attempt by a state to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process of law as guaranteed by the Fourteenth Amendment. That which is not in fact the taxpayer's income cannot be made such by calling it income. Compare *Nichols* v. *Coolidge,* 274 U. S. 531, 540."

A statute which imposes a tax upon assumptions of fact without regard to actualities is so arbitrary and capricious as to violate the Fifth Amendment. *Schlesinger* v. *Wisconsin,* 270 U. S. 230, 240; *Heiner* v. *Donnan,* 285 U. S. 312, 325-329.

The arbitrary character of the statute is especially apparent if it is applied to petitioner's annuities, purchased years before the adoption of the new provision. The amount of petitioner's tax is made to depend on past lawful transactions, which at the time did not produce income and which are beyond recall. *Nichols* v. *Coolidge,* 274 U. S. 531, 542; *Blodgett* v. *Holden,* 275 U. S. 142, 147; *Untermyer* v. *Anderson,* 276 U. S. 440, 445; *Helvering* v. *Helmholz,* 296 U. S. 93, 98.

Conclusion.

In order to establish the correct measure of taxability of annuities paid by charities, and to dispel the doubt and confusion that result from the decision of the Circuit Court of Appeals, it is respectfully submitted that the writ of certiorari should be granted.

Respectfully submitted,

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